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IN THE

Supreme Court of the United States

OCTOBER TERM, 1948.

No. 200.

STATE OF NEW YORK,
Petitioner,

200

vs.

LEONARD H. CARTER, as Trustee in Bankruptcy.

No. 201.

THE UNITED STATES OF AMERICA,
Petitioner,

201

vs.

LEONARD H. CARTER, Trustee of Union Fabrics, Inc.,
Bankrupt.

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR RESPONDENT.

SYDNEY W. CABLE,
Attorney for Respondent,
285 Madison Avenue,
New York, N. Y.

LESLIE KIRSCH,
Of Counsel.

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BRIEF FOR RESPONDENT.

Statement.

The case at bar and its companion case *Saper* v. *City of New York*, 168 F. (2d) 268 (C. C. A. 2, 1948), are the first since the amendments of the Bankruptcy Act in 1938 which directly present to this Court the question as to whether interest is allowable on priority tax claims in bankruptcy for the period subsequent to the filing of the petition in bankruptcy where there is no surplus.

Summary of Argument.

Petitioners have failed to prove that there is any statutory authority for allowance of interest on tax claims in bankruptcy after the date of the filing of the petition in bankruptcy. Section 57j of the Bankruptcy Act relied upon by petitioners is wholly irrelevant. *A fortiori*, the federal taxing statutes cited by the United States to support petitioners' construction of Section 57j are also irrelevant. The cases cited by petitioners, with the sole exception of *Davie v. Green*, 133 F. (2d) 451 (C. C. A. 1, 1943), which is founded upon an erroneous premise, do not support the proposition for which they are cited.

The rule urged by petitioners was of judicial origin. The only reasons stated in the cases, decided prior to the Chandler Act, for the allowance of interest on tax claims during bankruptcy were the favored status of tax claims under the Bankruptcy Act and administrative convenience. The amendments of the Bankruptcy Act in 1926 and particularly in 1938 (Chandler Act) rendered those reasons obsolete. The report of the House Committee on the Judiciary cited by petitioners concurs in that conclusion. Petitioners' other arguments to the contrary are insufficient. The only remaining issue therefore is whether the obsolete rule should be abrogated by this Court or whether it requires congressional action at some indefinite future time. Precedent and reason indicate that this Court should abrogate this rule of judicial origin in order to prevent the perpetuation of further inequities, inconsistencies and anomalies resulting from its application.

Bankruptcy courts have inherent and statutory equitable powers to disallow claims, in whole or in part,

on equitable grounds whether or not this Court determines to abrogate the rule urged by petitioners, the equitable considerations of the instant case are such as to require the exercise of the Court's discretion to disallow petitioners' claims to the extent of interest for the period subsequent to the filing of the petition in bankruptcy.

Argument.

I.

No statutory authority exists for the payment of interest on tax claims in bankruptcy for the period subsequent to the date of bankruptcy.

1. Irrelevancy of Section 57j:

The briefs of petitioners are permeated with the fundamental fallacy that Section 57j of the Bankruptcy Act directs allowance of interest on tax claims in bankruptcy for the period subsequent to the date of the filing of the petition in bankruptcy (Brief for the United States, pp. 6, 7, 9-14, 25; Brief for New York, pp. 5, 8-10).

Section 57j (11 U. S. C., Sec. 93j) provides:

> "Debts owing to the United States or any State or subdivision thereof as a *penalty or forfeiture*[1] shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued thereon according to law."

[1] Italics in this and all subsequent quotations herein ours unless otherwise indicated.

Both petitioners construe the foregoing unambiguous language as though it covered all debts owing to the United States or any State or subdivision thereof and as though it required payment of interest on all such debts subsequent to the date of bankruptcy.

Clearly Section 57j relates only to debts owing as a "penalty or forfeiture". No need to invoke the interest provision can ever arise unless, as a condition precedent, the debt is one for a penalty or forfeiture.

Section 57j has no relevancy whatever to any case such as the instant case where there is no question of a penalty or forfeiture.

> *People of the State of New York* v. *Jersawit*, 263 U. S. 493 (1924);
> *United States* v. *Childs*, 266 U. S. 304 (1924);
> *Meilink* v. *Unemployment Reserves Commission of California*, 314 U. S. 564 (1942).

Accordingly the allowance of interest on tax claims cannot be justified by any of the provisions of Section 57j.

2. Analysis of Cases Cited to Support Petitioners' Construction of Section 57j:

The United States and the State of New York have expressly asserted that the federal courts have "repeatedly found in Section 57j the command that interest shall be allowed on tax claims during bankruptcy and until the date of payment" (Brief for the United States, p. 13) and that "interest on tax claims to the date of payment was allowed under the authority of Section 57j" (Brief for New York, p. 5).

Only one of the cases cited by petitioners supports such contentions (*Davie* v. *Green*, 133 F. (2d) 451

(C. C. A. 1, 1943). That decision in so far as it determines that interest on tax claims in bankruptcy is allowable to the date of payment, is founded on an erroneous premise. The primary question before that Court was whether the New Hampshire unemployment compensation statute provision for interest at the rate of 1% a month was a penalty or interest. That Court held that the impost was interest and not a penalty. Nevertheless, it paradoxically went on to rely on the language of Section 57j to hold that, in bankruptcy, interest on unpaid taxes continues until the date of payment.

Respondent has hereinbefore demonstrated that Section 57j has no application to the question of interest on tax claims in bankruptcy unless the debt involves a penalty or forfeiture. Section 57j was therefore irrelevant to the decision on the interest aspect of the *Davie* case since the first holding in that case was that the impost was not a penalty but interest.

The argument of the Court of Appeals in *Davie* v. *Green, supra,* adopted by petitioners, that since there was no material amendment of Section 57j in 1938, Congress intended to re-enact the prior rule of allowance of interest on tax claims to the date of payment, is therefore without foundation.[2]

The United States cites *In re J. Menist & Co.*, 290 Fed. 947 (C. C. A. 2, 1923), as the leading case and the decision of this Court in the same case *sub nomine United States* v. *Childs*, 266 U. S. 304 (1924), in support of petitioners' construction of Section 57j.

[2] See *Saper* v. *City of New York, supra*, pp. 270-271, from which it appears that there is no evidence to indicate that the problem was ever under consideration by Congress at the time of or prior to the enactment of the Chandler Act.

Respondent respectfully disagrees. In the *Menist* case the United States filed a claim in bankruptcy for the amount of income taxes in default plus 5% penalty and 1% interest per month until paid. Subsequently the United States withdrew its claim for the penalty of 5%. The District Court held that the interest of 1% a month amounted to a penalty and allowed the claim in the amount of the taxes in default, with interest at 6% to the date of payment. In affirming, the Court of Appeals cited Section 57j and held that exaction of 1% a month amounted to a penalty to the extent of anything in excess of the legal rate of interest.

In the *Menist* case, therefore, the Court of Appeals properly held that Section 57j was applicable because it found the exaction to include a penalty, much as this Court later held in the case of *People of the State of New York* v. *Jersawit*, 263 U. S. 493 (1924). Moreover it should be noted that the Court of Appeals allowed 6% of the amount of the taxes in default as "the pecuniary loss" sustained and not as "interest" provided for by Section 57j.

The *ratio* of that case is clear only when it is understood that the Court of Appeals was dealing with a bankruptcy claim for a penalty. Nothing in the *Menist* decision justifies the conclusion of petitioners that Section 57j directs or authorizes payment of interest on tax claims as such after the date of the bankruptcy.

On appeal, this Court did not approve petitioners' construction of Section 57j as petitioners allege. On the contrary, this Court held that the provision for interest of 1% a month was not a penalty but was interest. This Court quoted Section 57j of the Bank-

ruptcy Act only for consideration in connection with the clear and complete distinction made in the relevant tax statute between penalty and interest.

In reversing the judgment of the Court of Appeals in the *Monist* case, it is true that this Court allowed statutory interest to the date of payment. It did so, however, without discussing the question at bar. The *Childs* case was decided prior to the amendments to the Bankruptcy Act in 1926 and 1938, the effect of which are hereinafter discussed (pp. 13-17, *infra*). Nothing in this Court's opinion in the *Childs* case supports petitioners' construction of Section 57j.

None of the other cases cited by petitioners expressly or by implication refer to Section 57j as the basis for the allowance of interest after the filing of a petition in bankruptcy.[3]

3. Irrelevancy of Federal Taxing Statutes:

In determining the legality and priority of tax claims in bankruptcy, the Bankruptcy Act is paramount over all other federal and state statutes.

United States v. *New York*, 315 U. S. 510 (1942);
City of New York v. *Feiring*, 313 U. S. 283 (1941);
Missouri v. *Ross*, 299 U. S. 72 (1936);
Guarantee Title & Trust Co. v. *Title Guaranty & Surety Co.*, 224 U. S. 152 (1912);
In re Standard Composition Co., 23 F. Supp. 391 (E. D. Mich., 1938).

The United States, realizing this well settled doctrine, cites a number of federal taxing statutes only

[3] See 3 Collier on Bankruptcy (14th Ed.), p. 1841, n. 34, for a discussion of the cases.

as confirmatory of the petitioners' construction of Section 57j (Brief for the United States, p. 14).

Respondent has proved conclusively that Section 57j is irrelevant to the determination of the instant case since no penalty or forfeiture is involved. It necessarily follows therefore that the federal taxing statutes and regulations cited by the United States are also irrelevant.

In *Saper* v. *City of New York*, *supra*, the Court of Appeals answered this argument of the United States as follows (p. 271, n. 8):

> "In the companion case, the United States devotes much attention to various of the federal revenue laws and congressional debates as to changes in them with respect to interest against estates held by fiduciaries. But these do not offer any clear-cut solutions in themselves and are hardly available to change the stated priorities of a bankruptcy act. Obviously the intent of the latter is to treat federal, state, and municipal tax claims alike; it would be quite improper to accord the former alone some advantage based upon some newly discovered other federal law or regulation."

The determinative principle of law overlooked by the United States in citing its taxing statutes and regulations is that when bankruptcy occurs, the Bankruptcy Act supersedes all other federal statutes.[4]

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[4] The Courts have consistently held, for example, that 31 U. S. C., Sec. 191, which gives the United States an absolute priority for its debts in cases of insolvency, does not control in bankruptcy proceedings since the Bankruptcy Act itself has established the order of priority of debts (*Davis* v. *Pringle*, 268 U. S. 315 (1925); *Guarantee Title & Trust Co.* v. *Title Guaranty & Surety Co.*, 224 U. S. 152 (1912); *In re Knox-Powell-Stockton Co.*, 100 F. (2d) 972 (C. C. A. 9, 1939).

4. Summary:

Petitioners have failed to prove that there is any statutory authority for allowance of interest on tax claims in bankruptcy after the date of the filing of the petition in bankruptcy.[5] Section 57j of the Bankruptcy Act relied upon by petitioners is wholly irrelevant. *A fortiori*, the federal taxing statutes cited by the United States to support petitioners' construction of Section 57j are also irrelevant. The cases cited by petitioners, with the sole exception of *Davie* v. *Green, supra*, which is founded upon an erroneous premise, do not support the proposition for which they are cited.

II.

The amendments of the Bankruptcy Act of 1938 have rendered obsolete the rule urged by petitioners.

1. Origin of the Rule:

The only expressed justification to be found in the cases decided prior to the Chandler Act for the allowance of interest on tax claims during the bankruptcy period was the favored status enjoyed by tax claims and administrative convenience.

In *Saper* v. *City of New York, supra*, the Court

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[5] Statutes involving priorities of claims in bankruptcy are strictly construed and the burden rests on the claimant asserting priority to establish that the claim asserted comes within the intended class (*In re Paradise Catering Corp.*, 36 F. Supp. 974 (S. D., N. Y., 1941); *In re Witt Dairy Co.*, 48 F. Supp. 964 (N. D., Cal., 1942); *In re Public Ledger*, 63 F. Supp. 1008 (E. D., Pa., 1945)).

of Appeals described the evolution of the rule and the reasons which prompted it as follows (p. 269):

> "For reasons both of administrative convenience and of fundamental justice and equity it has been steadily held, following the English practice, that interest does not accrue upon claims during the period of bankruptcy administration. *Sexton* v. *Dreyfus*, 219 U. S. 339, 344; *Vanston Bondholders Protective Committee* v. *Green*, 329 U. S. 156, 163, 165; 3 Collier, *loc. cit., supra.*[3] A single exception, that for tax claims, was developed judicially. It appears to have begun with *In re Kallak*, D. C. N. D., 147 F. 276, though the contemporaneous case of *In re William F. Fisher & Co.*, D. C. N. J., 148 F. 907, held to the contrary. But the *Kallak* case set the pattern and was followed by other cases, including *In re J. Menist & Co.*, 2 Cir., 290 F. 947, which, however, allowed interest only at the legal rate. When the Supreme Court reversed this holding to allow interest at the statutory rate, though without separate discussion of our particular problem, *United States* v. *Childs*, 1924, 266 U. S. 304, the matter was considered settled. The reason for the rule was that the original Bankruptcy Act treated tax claims quite differently from other debts; instead of requiring their presentation in due course, it provided that 'the court shall order the trustee to pay all taxes legally due and owing by the bankrupt to the United States, State, county, district, or municipality in advance of the payment of dividends to creditors.' § 64, sub. a, 11 U. S. C. A. § 104, sub. a, before amendment. Hence the trustee was, in effect, compelled to search them out. So taxes

were in altogether a separate class; they were to be paid before any administration of the estate, properly speaking, and thus had an absolute priority over the bankrupt's debts. In view of this peculiarly favored position, the like result as to interest was certainly not unnatural, even if not compelled.

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3 If, however, a sufficiency of assets develops, the claims will bear interest; and though the usual rule applies also to secured claims, yet where the security itself yields interest or dividends, those are applicable to interest on the claims. 3 Collier, *loc. cit. supra*."

The reasoning of the Court in *In re Kallak*, 147 Fed. 276 (D. C. N. D., 1906), was as follows (p. 277):

"There are two reasons why ordinary claims of creditors are not permitted to draw interest subsequent to the adjudication: First, it is important that the proportionate interest of the several creditors in the estate be ascertained and fixed. If interest were to accrue, however, after the adjudication, the amount of the several claims would vary from time to time, according to their respective rates of interest and the proportionate share of the several creditors would be subject to constant readjustment. The second reason is the convenience of administration. If, at the declaration of every dividend, a new basis of apportionment were required, depending upon varying rates of interest, the administration of the estate would be seriously complicated. *Chemical National Bank* v. *Armstrong*, 59 Fed. 372, 379, 8 C. C. A. 155, 28 L. R. A. 231; *White* v. *Knox*, 111 U. S. 784, 4 Sup. Ct. 686, 28 L. Ed. 603. In the case of public taxes, neither of these reasons

has any application because they do not share the estate with the claims of private creditors. On the contrary, section 64a expressly provides that before anything shall be paid to the creditors by way of dividends all taxes owing by the bankrupt shall be fully discharged. The reason for claims becoming fixed at the date of the adjudication, so that interest shall not subsequently accrue having no application to public taxes, the rule itself should not be applied in such cases."

The *ratio* of the *Kallak* case was, in our opinion, of doubtful validity since it contravened the fundamental bankruptcy principle that the assets of an insolvent estate constitute a trust fund *in custodia legis* and the delay in distribution is necessary for the orderly administration of the estate and should not operate to benefit or prejudice any creditor.

Thomas v. *Western Car Company*, 149 U. S. 95, 116 (1893);
Sexton v. *Dreyfus*, 219 U. S. 339, 344 (1911);
Vanston Committee v. *Green*, 329 U. S. 156, 163, 165 (1946).

Apparently the Courts which allowed interest on tax claims in bankruptcy to the date of payment in cases decided prior to *Davie* v. *Green, supra,* did so, with one immaterial exception,[6] either without discussion

[6] *In re Semon*, 11 F. Supp. 18 (D. C. Conn., 1935), mod. 80 F. (2d) 81 (C. C. A. 2, 1935). The District Court allowed interest during bankruptcy on the authority of Sec. 294(e) of the 1928 Revenue Act. The question was not before the Court of Appeals. The case has never been followed on that ground.

of that point whatsoever[7] or for the reasons stated in *In re Kallak, supra*.[8]

Consequently the only known grounds for the allowance of interest on tax claims during bankruptcy are those presented in the *Kallak* case and cases which adopted its reasoning.

2. Statutory Amendments Subsequent to *United States* v. *Childs, supra*:

The statutory changes enacted in 1926 and 1938 and the effect thereof on the *ratio* of the *Kallak* case were summarized by the Court of Appeals for the Second Circuit in *Sapery* v. *City of New York, supra*, as follows (p. 270):

> "In 1926, however, § 64, sub. a, was amended, by adding the words 'in the order of priority as set forth in paragraph (b)'; and of the seven

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[7] *Meilink* v. *Unemployment Reserves Com.*, 314 U. S. 564 (1942); *United States* v. *Childs, supra*; *People of the State of New York* v. *Jersawit*, 263 U. S. 493 (1924), (see *In re Semon, supra*, where the District Court stated as to the holding of this Court in the *Jersawit* case (p. 20) "There being no appeal by the trustee in bankruptcy, the allowance of 6% interest was permitted to stand."); *In re Beardsley & Wolcott Mfg. Co.*, 82 F. (2d) 239 (C. C. A. 2, 1936); *In re Martin*, 75 F. (2d) 618 (C. C. A. 7, 1935); *Horn & Boone County, Neb.*, 44 F. (2d) 920 (C. C. A. 8, 1930); *In re Standard Composition Co.*, 23 F. Supp. 391 (D. C. E. D. Mich., 1938); *In re A. E. Fountain*, 295 Fed. 873 (D. C. S. D. N. Y., 1924).

[8] *Dayton* v. *Stanard*, 241 U. S. 588 (1916); *In re J. Menist & Co., supra*, rev'd *sub nom. United States* v. *Childs, supra*; *In re Ajax Dress Co.*, 290 Fed. 950 (C. C. A. 2, 1923), rev'd *sub nom. People of the State of New York* v. *Jersawit, supra*; *In re Clark Realty Co.*, 253 Fed. 938 (C. C. A. 7, 1918); *In re L. Gandolfi & Co.*, 42 F. Supp. 706 (D. C. S. D. N. Y., 1940); *In re Ashland Emery & Corundum Co.*, 229 Fed. 829 (D. C. Mass., 1916).

priorities provided in b, taxes came sixth or next to the last. Even that change might have been considered sufficient to reduce taxes to the status of debts in view of the obvious doubt as to the payment of interest upon a sixth claim in a series where the earlier five admittedly carried none. Moreover, § 64, sub. b, spoke of the debts 'to have priority' in advance of the payment of dividends to creditors, 'and to be paid in full out of bankrupt estates,' in the order then stated; it was at least odd to think that a wage claim up to $600 was 'paid in full' when paid without interest, whereas a tax claim of later priority was not so paid until interest of 12 per cent or more was included.' But the issue did not come before the Supreme Court; and apparently the lower federal courts continued their former practice. *Cf. Horn* v. *Boone County, Neb.*, 8 Cir., 44 F. 2d 920; *In re Semon*, D. C. Conn., 11 F. Supp. 18, modified on other grounds 2 Cir., 80 F. 2d 81.

At any rate the process of assimilation of tax claims to other debts appears, to us at least, to have been completed by the Chandler amendments of 1938. Indeed we thus described the changes in *United States* v. *Roth*, *supra*, 164 F. 2d at pages 577, 578: 'By the 1938 amendments, however, taxes were classified as "debts" within section 64, sub. a, 11 U. S. C. A. § 104, sub. a, and section 57, sub. n, 11 U. S. C. A. § 93, sub. n, was broadened to include "all claims of the United States" and require them to "be proved and filed in the manner provided in this section."' Subdivision a of section 57, 11 U. S. C. A. § 93, sub. a, provides that a proof of claim shall state

among other matters "that the claim is justly owing from the bankrupt to the creditor"; * * * Thus it is apparent that the Act, as it now stands, treats the tax claim as a debt and the United States as a creditor which, like other creditors, must make proof of claim on a form prescribed by the Supreme Court. This, then, took from tax claims their former favored position where no proof or other governmental action was necessary for their enforcement. Thenceforth they must be proved, or otherwise be barred, just like other debts of the bankrupt.

[4] For the meaning of 'paid in full' as limited to the principal, see *Hammer* v. *Tufts*, *supra*, 145 F. 2d at page 449.

[5] In addition, by these amendments, the priority subdivision formerly paragraph 64b became paragraph 64a, and the classes of priorities were changed to five instead of seven, the status of tax claims being still next to the last or (4) instead of (6). This was no advancement in position, since former classes (1), (2), and (3) were combined with (1). In 1946, there was added to (1) 'the fees for the referees' salary fund and for the referees' expense fund.' (This note is not a part of the quotation.)"

The inescapable conclusion resulting from such statutory changes was stated by the Court of Appeals for the Second Circuit in the *Saper* case as follows (p. 270):

"We see no reason to suppose that this did not place tax claims in the same situation as other debts with respect to interest also.[6] The chief ground taken in *Davis* v. *Green*, *supra*, and the other cases which argue for the priority of interest, as well as principal, though conceding its inequity, is that Congress by failing to exclude it has re-enacted the old rule. It is dubious at best to rely upon such Congressional adoption where

'a close scrutiny of the various reports and hearings on the Chandler Act or its predecessor bills reveals nothing to indicate that the problem was ever under consideration.' 3 Collier on Bankruptcy, 1946 Cum. Supp., at n. 28a of par. 63.16; 61 Harv. L. Rev. 354. But it is submitted with deference that the pitch is on the other foot. When Congress provided that taxes must be proven like other debts and put them in, and well down in, a hierarchy of other claims, none of which bore interest, we think that like treatment was intended unless some specific exception was stated. This seems all the more likely when we recall the dubious and uncertain history of the original judicial exception.

This conclusion seems to us fortified by arguments of practicality and convenience—if not of equity, as stressed by Judge Bright—which would naturally appeal to legislators or draftsmen, if a careful exploration of the subject is to be attributed to them. Of course, the allowance of accruing interest to these various state and governmental units 'would necessitate' constant rescheduling and recomputation of dividends available.' 61 Harv. L. Rev. 354, 355. And the net result will be to promote tax claims beyond what seems the clear intent of the statute.' Moreover, with the very heavy interest rates now collected by states and municipalities and upheld in *Meilink* v. *Unemployment Reserves Commission of State of California*, 314 U. S. 564, it is apparent that any bankrupt estate whose settlement is delayed for any period of time is likely to be

eaten up by the accruing interest on the various taxes now levied against business enterprises.

[6] By making a tax claim a debt of the bankrupt it is brought within the terms of § 63, subd. a, 11 U. S. C. A. § 103, sub. a, defining provable debts, of which subd. (1) allows interest only up to the filing of the petition, and subd. (5) includes provable debts reduced to judgment after filing, i. e., less costs incurred and interest after the filing. Hence under subd. (5), when a tax claim is reduced to judgment after the filing, interest must be deducted. This points up the anomaly of another rule for tax claims not reduced to judgment.

[7] Assume a bankrupt to owe $1,000 to an employee for wages, $1,000 each to three taxing authorities, and $1,000 for rent given priority under state law. Under § 64, sub. a, which gives priority to the amount of $600 for wages and allows the others in order, these would be all paid in full if the assets were $5,000, and there were no other general claims beyond the $400 balance on the wage claim. But with interest allowed on the tax claims at 12% (or perhaps more) per annum during the bankruptcy, possible payments on the later claims would diminish in size as rapidly as Alice in Wonderland."

3. Refutation of Petitioners' Arguments on Effect of Chandler Act Amendments:

The principal reasons advanced by petitioners in an attempt to avoid the inescapable conclusion reached by the Court in *Saper* v. *City of New York*, *supra*, are:

1. The United States urges that in making a thorough revision of the Bankruptcy Act in 1938 the draftsmen must have been aware of the interest rule and that failure to amend that rule and specifically failure to change Section 57j indicated a contrary congressional intent.

This argument can be answered very briefly. In the first place, Section 57j has been proved to be irrelevant to the determination of the question at bar.

Secondly, the text writers in 3 Collier on Bankruptcy (14th Ed., 1946 Cum. Supp.), par. 63.16, replied to the same argument as advanced by the

Court in *Davie* v. *Green*, *supra*, as follows (p. 132, n. 28(a)):

> "Issue may be taken, however, with the Court in *Davie* v. *Green* on its conclusion that the draftsmen of the Chandler Act of 1938, or Congress, considered the doctrine in question and decided to affirm it. A close scrutiny of the various reports and hearings on the Chandler Act or its predecessor bills reveals nothing to indicate that the problem was ever under consideration, much less approved, unless silence is deemed to signify approval. It is quite enlightening that in *Matter of the D. O. Summers Co.*, cited and quoted in the Treatise, n. 24, Referee Friebolin—who was one of the principal draftsmen of the Chandler Act—made no mention of or reference to any discussion of the problem occurring during the drafting of the Act or its Congressional consideration. In light of his remarks regarding the doctrine, it is clear that he would have done so had the matter actually been raised and considered."

2. The United States urges that an intention to make a change adverse to it or to the states or their subdivisions should be supported by stronger evidence than presented by the Chandler Act amendments. The Court of Appeals for the Second Circuit answered this argument as follows in *Saper* v. *City of New York* (p. 271):

> "But it is submitted with deference that the pinch is on the other foot. When Congress provided that taxes must be proven like other debts and put them in, and well down in, a hierarchy of other claims, none of which bore interest, we

think that like treatment was intended unless some specific exception was stated. This seems all the more likely when we recall the dubious and uncertain history of the original judicial exception."

3. The United States urges that the decision of the Court of Appeals for the Second Circuit has granted a tax exemption on a mere implication.

It is respectfully submitted that this contention ignores the express provisions of Sections 57 n, 63 a and 64 a as discussed in the *Saper* case at page 270 n. 6 (p. 17, *supra*).

4. Petitioners unite in citing H. R. 5693 (80th Congress, 2d Sess.) and Report No. 2083 of the House Committee on the Judiciary with respect thereto as conclusive proof of congressional intent not to change the rule of the *Kallak* case by the 1938 amendments.

H. R. 5693 and Report 2083, on the contrary, support the contentions made by respondent.

The proposed amendment of Section 57j as contained in H. R. 5693, Section 11, is inconsistent with petitioners' interpretation of Section 57j in its present form. In the proposed amendment, the House of Representatives distinguished very sharply between debts owing as a penalty (subdivision (1)) and taxes due and owing (subdivision (2)). If petitioners were correct in their construction of Section 57j in its present form, there would be no need for subdivision (2), assuming without conceding that any amendment is required.

The report of the House Committee on the Judiciary agrees with the contentions of respondent and with the Court of Appeals for the Second Circuit in its deci-

sion in *Saper* v. *City of New York*, *supra*. It is clear from that report that the rule as to interest on delinquent tax debts is an exception to the general rule of interest on debts in bankruptcy; that the rule was of judicial origin; and most significantly that the changes in the Bankruptcy Act effected by the Chandler Act rendered the reasoning in the *Kallak* case obsolete.

The only issue therefore is whether the outmoded rule should be abrogated by this Court or whether legislative action must be taken.

4. Reasons for this Court to Act:

It is the function of the Courts to interpret congressional action. It is indisputable that the action taken by Congress in enacting the Chandler Act rendered the reasons for the rule urged by petitioners obsolete.

In numerous instances this Court, while conceding the power of Congress to enact remedial legislation, has asserted its own inherent power and responsibility to discard outmoded rules, without awaiting congressional action.

In *Aetna Portland Cement Co.* v. *Federal Trade Com'n*, 157 F. (2d) 533 (C. C. A. 7, 1946), the Court of Appeals in its majority opinion, set forth arguments with respect to the necessity of congressional action almost identical with those urged in the instant case (p. 573):

> "Furthermore, the basing point price system has been in use by industry for almost a half-century. There has been and is a marked diversity of opinion among economists, lawmakers and people generally as to whether it is good or bad.

Numerous bills have been introduced in Congress seeking to outlaw its use. Countless time has been spent in hearings by Congressional committees, before whom it has been assailed and defended. The pages of the Congressional Record bear mute but indisputable proof of the fact that Congress has repeatedly refused to declare its use illegal. There is no occasion to relate this Congressional history. It is a matter of common and general knowledge. In the *Corn Products* case, the court in commenting upon some of this legislative history stated (324 U. S. at page 737, 65 S. Ct. at page 967, 89 L. Ed. 1320): 'We think this legislative history indicates only that Congress was unwilling to require f. o. b. factory pricing, and thus to make all uniform delivered price systems and all basing point systems illegal *per se*.' Notwithstanding this Congressional attitude as recognized by the Supreme Court, this court is now urged to hold that the system is illegal *per se*, and to require that cement be sold on an f. o. b. plant basis.

In our judgment, the question as to whether the basing point price system should be declared illegal rests clearly within the legislative domain. We know of no criticism so often and so forcibly directed at courts, particularly Federal courts, as their propensity for usurping the functions of Congress. If this pricing system which Congress has over the years steadfastly refused to declare illegal, although vigorously urged to do so, is now to be outlawed by the courts, it will mark the high tide in judicial usurpation."

Nevertheless, on appeal *sub nomine Fed. Trade Com.* v. *Cement Institute*, 333 U. S. 683 (1948), this

Court reversed the Court of Appeals for the Seventh Circuit. There is no discussion of this point in the majority opinion of this Court but the above quoted argument was noted and quoted in footnote 11 in the dissenting opinion.

In *Erie R. Co.* v. *Tompkins*, 304 U. S. 64 (1938), Mr. Justice Reed in a concurring opinion overruling the long established doctrine of *Swift* v. *Tyson* stated (p. 92):

> "In this Court, stare decisis, in statutory construction, is a useful rule, not an inexorable command."

In *Funk* v. *United States*, 290 U. S. 371 (1933), this Court taking cognizance of altered conditions with respect to a common law rule as to competency of witnesses declared (p. 381):

> "It may be said that the court should continue to enforce the old rule, however contrary to modern experience and thought, and however opposed, in principle, to the general current of legislation and of judicial opinion, it may have become, leaving to Congress the responsibility of changing it. Of course, Congress has that power; but if Congress fail to act, as it has failed in respect of the matter now under review, and the court be called upon to decide the question, is it not the duty of the court, if it possess the power, to decide it in accordance with present day standard of wisdom and justice rather than in accordance with some outworn and antiquated rule of the past?"

In *Helvering* v. *Hallock*, 309 U. S. 106 (1940), this Court in rejecting the diversities taken in a former

opinion in applying an earlier doctrine of this Court stated (p. 122):

> "By imputing to Congress a hypothetical recognition of coherence between the Klein and the St. Louis Union Trust Co. Cases, we cannot evade our own responsibility for reconsidering, in the light of further experience, the validity of distinctions which this Court has itself created."

Moreover, in the instant case there is no change of position on the part of any municipal, State or Federal tax authority which might cause this Court to hesitate to change the rule which has ceased to have any reason for being perpetuated (*Cf. Helvering* v. *Hallock*, *supra*, 119-121).

Further reason may be found in the following pertinent statement in *In re Standard Composition Co.*, 23 F. Supp. 391 (D. C. E. D. Mich., 1938) (p. 395):

> "The Bankruptcy Act, 11 U. S. C. A. § 1 *et seq.*, was drafted with the principle that 'equality is equity' in mind, but there has been a tendency in recent years for the typical bankruptcy proceeding to resolve itself into a process in which one preferred party after another slices off a portion of the available assets, with little or none remaining for distribution to general creditors. This process ought not to be extended beyond the clear requirements of the controlling statutes."

5. Summary:

Respondent has conclusively established that the reasons for the rule urged by petitioners have been destroyed by the amendments to the Bankruptcy Act

in 1938. The report of the House Committee cited by petitioners concurs in that conclusion. The only remaining issue therefore is whether the obsolete rule should be abrogated by this Court or whether it requires congressional action at some indefinite future time. Precedent and reason indicate that this Court should abrogate this rule of judicial origin in order to prevent the perpetuation of further inequities, inconsistencies and anomalies resulting from its application.

III.

Equitable considerations of the instant case require the exercise of the Court's power to disallow tax claims to the extent of interest thereon for the period subsequent to the date of the filing of the petition in bankruptcy.

Both the District Court and the Court of Appeals held as a rule of general application that priority tax claims in bankruptcy should be treated no differently than other claims, insofar as interest is concerned. Respondent believes that the judgment appealed from should be affirmed on that ground.

Whether or not this Court determines to adopt the general rule, the judgment appealed from herein should be affirmed by reason of the equitable considerations present in the instant case.

1. Inherent and Statutory Equitable Power of the Court:

In *Continental Illinois Bank and Trust Co. v. Chicago Rock Island & Pacific Railway Company*, 294 U. S. 648 (1935), this Court held (p. 675):

"By § 2 of the Bankruptcy Act (U. S. C.

> title 11, § 11), courts of bankruptcy are invested 'with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in bankruptcy proceedings.' They are essentially courts of equity, and their proceedings inherently proceedings in equity, the words 'at law' probably having been inserted only with regard to clause (4) of § 2, which confers authority to arraign, try and punish bankrupts and others for violations of the act. * * *"

To the same effect, see *Pepper* v. *Litton*, 308 U. S. 295, 303 (1939); *Prudence Realization Corporation* v. *Geist*, 316 U. S. 89, 95 (1942); *Young* v. *Higbee Co.*, 324 U. S. 204, 214 (1945).

Section 57 k of the Bankruptcy Act (11 U. S. C., Section 93 k provides:

> "Claims which have been allowed may be reconsidered for cause and reallowed or rejected in whole or in part according to the *equities* of the case, before but not after the estate has been closed."

In the exercise of such equitable powers, the bankruptcy courts have in appropriate cases subordinated one creditor's claim to others to prevent a course of conduct which would be fraudulent or otherwise inequitable as to other creditors.

> *Heiser* v. *Woodruff*, 327 U. S. 726 (1946);
> *Pepper* v. *Litton*, *supra*;
> *Haussen* v. *Wingren*, 121 F. (2d) 1011 (C. C. A. 10, 1941), cert. den. *sub nom.* *Wingren* v. *Haussen*, 314 U. S. 683 (1941);

Corley v. *Cozart*, 115 F. (2d) 119 (C. C. A. 5, 1940);

Stone v. *Eacho*, 127 F. (2d) 284 (C. C. A. 4, 1942).

Thus it is incontrovertible that the bankruptcy court has both inherent and statutory powers to disallow a claim, whether priority or otherwise, in whole or in part, according to the equities of the case.

2. Equitable Considerations of the Instant Case:

There was unceasing litigation in the instant case for over six years (R. 4-5). By a petition verified October 25, 1940 a turnover proceeding was commenced against the bankrupt's president and a turnover order was procured on February 23, 1943 (R. 4). Appeals were taken by the bankrupt's president to the District Court, to the Court of Appeals and a petition for certiorari was filed with this Court which was denied (R. 4-5). Application was made to reopen the turnover proceeding and upon denial thereof further appeals ensued and another application was made to this Court for a writ of certiorari which was denied (R. 4-5). A contempt order was obtained by respondent and that too was the subject of appeals and an application for a writ of certiorari to this Court which was denied (R. 5).

As a direct result of that litigation over a period of six years, a settlement was procured resulting in the payment of $30,000.00 into the estate (R. 5, 6).

Prior to the receipt of the settlement the assets of the estate were approximately $20,000.00. (R. 6). The priority tax claims, namely those of the United States, the State of New York and The City of New York,

aggregated over $15,000.00 (R. 5, 6). Interest on the claims of the United States and of the State of New York to the date of the filing of the petition in bankruptcy aggregated over $1,200.00 (R. 6). Claims of general creditors aggregated approximately $74,000.00 (R. 5). Substantial administration expenses will have to be paid.

It would be unconscionable to permit priority tax claims to draw interest for the very period required to increase the estate to such an extent that it is enabled to pay not only principal of the tax claims in full, instead of just a portion thereof, but also interest for such period. "Such a ruling compels payment, not by the debtor whose debt it is, but by general creditors, who did not incur it, and who were not responsible for the delay in payment out of their otherwise fractional recovery on their own claims" (R. 16). It is manifestly inequitable and contrary to a fundamental principle of bankruptcy to permit priority creditors to benefit by reason of such unavoidable delay at the expense of general creditors (*Vanston Committee* v. *Green*, *supra*).

3. Refutation of Argument as to the Sufficiency of Estate:

The State of New York asserts at pages 11 and 12 of its Brief that respondent had sufficient assets prior to the receipt of the settlement to pay the priority tax claims and still have a balance of more than $3,563.55 for administration expenses.

That sum of less than $3,600.00 is obviously insufficient to cover the Referee's fees, Trustee's fees, fees to counsel and accountants for nine years of services (R. 3), and other administration expenses. In view of the manner in which the bankrupt's presi-

dent litigated the various issues (R. 546), respondent could not prudently have paid any claims because he could not prior to the settlement reasonably estimate the administration expenses which have first priority (Section 64(a) (1)). As soon as an acceptable offer of settlement was made, and even prior to its formal acceptance, when it became apparent that the question now before this Court was not merely an academic one, respondent moved promptly to object to the claims of the United States and the State of New York (R. 3).

4. Summary.

Petitioners have cited no authority which would controvert the inherent and statutory equitable powers of the bankruptcy court to disallow their claims to the extent of interest for the period after the filing of the petition in bankruptcy. Petitioners have advanced no arguments sufficient to overcome the overwhelming equities of the instant case.

CONCLUSION.

The judgment of the Court of Appeals for the Second Circuit should be affirmed.

Dated, New York, N. Y., December 3, 1948.

Respectfully submitted,

SYDNEY W. CABLE,
Attorney for Respondent.

LESLIE KIRSCH,
Of Counsel.

APPENDIX.

Section 57 n of the Bankruptcy Act of 1898 was as follows:

"Claims shall not be proved against a bankrupt estate subsequent to one year after the adjudication; or if they are liquidated by litigation and the final judgment therein is rendered within thirty days before or after the expiration of such time, then within sixty days after the rendition of such judgment: *Provided*, That the right of infants and insane persons without guardians, without notice of the proceedings, may continue six months longer."

Section 57 n, as amended by the Chandler Act, is as follows:

"Except as otherwise provided in this Act, all claims provable under this Act, including all claims of the United States and of any State or subdivision thereof, shall be proved and filed in the manner provided in this section. Claims which are not filed within six months after the first date set for the first meeting of creditors shall not be allowed: * * *." [July 1, 1898, 30 Stat. at L. 544, chap. 541, § 57; Feb. 5, 1903, 32 Stat. at L. 797, chap. 487, § 12; May 27, 1926, 44 Stat. at L. 662, chap. 406, § 13; June 22, 1938, 52 Stat. at L. 802, chap. 575, § 1 (11 U. S. C. A. § 93).]

Section 64 of the Bankruptcy Act of 1898 was as follows:

"(a) The court shall order the trustee to pay all taxes legally due and owing by the bankrupt to

the United States, State, county, district, or municipality in advance of the payment of dividends to creditors, and upon filing the receipts of the proper public officers for such payment he shall be credited with the amount thereof, and in case any question arises as to the amount or legality of any such tax the same shall be heard and determined by the court.

(b) The debts to have priority; except as herein provided, and to be paid in full out of bankrupt estates, and the order of payment shall be (1) the actual and necessary cost of preserving the estate subsequent to filing the petition; (2) the filing fees paid by creditors in involuntary cases; (3) the cost of administration, including the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the petitioning creditors in involuntary cases, to the bankrupt in involuntary cases while performing the duties herein prescribed, and to the bankrupt in voluntary cases, as the court may allow; (4) wages due to workmen, clerks, or servants which have been earned within three months before the date of the commencement of proceedings, not to exceed three hundred dollars to each claimant and (5) debts owing to any person who by the laws of the States or the United States is entitled to priority."

Section 64, as amended in 1926, was as follows:

"(a) The court shall order the trustee to pay all taxes legally due and owing by the bankrupt

to the United States, State, county, district, or municipality, in the order of priority as set forth in paragraph (b) hereof: * * *.

(b) The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment shall be * * * (6) taxes payable under paragraph (a) hereof * * *."

Section 64, as amended by the Chandler Act, is as follows:

"(a) The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment shall be * * * (4) taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof: * * *." [July 1, 1898, 30 Stat. at L. 544, chap. 541, § 64; Feb. 5, 1903, 32 Stat. at L. 797, chap. 487, § 14; May 27, 1926, 44 Stat. at L. 662, chap. 406; June 15, 1906, 34 Stat. at L. 267, chap. 3333; June 22, 1938, 52 Stat. at L. 802, chap. 5757, § 1 (11 U. S. C. A. § 104).]